POSSIBLE RATIONALES FOR RENT REGULATION

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1 INTRODUCTION

Rent control has been one of the most controversial government policies in recent years. Controls have their vociferous critics and their equally vociferous supporters, who have variously demanded that the Government of Ontario make rent regulation more stringent, reform it, or abolish it altogether. The purpose of this paper is to discuss the rationales for rent regulation.

It is hoped this paper will contribute to the deliberations of the Commission of Inquiry into Residential Tenancies and also to the public debate about rent regulation. It is not intended as an evaluation of whether rent regulation should be continued in Ontario or of possible reforms. Its aim is to explore the relationships between objectives, the operation of housing markets, and policy recommendations. It is to explore the logic of argument about policy, not to advocate policy.

The paper begins by asking what the basic values of our society are that can be used to justify a government policy. For it is these values that permit us to judge whether the results of a government policy are desirable or not and therefore whether or not the policy is desirable. Suppose society holds that all people are entitled to adequate housing, and suppose it proves that some households do not have adequate housing. Then alternative housing policies can be considered; if the value of the increase in the consumption of adequate housing is greater than the value of what has been given up to achieve the increase, then the policy is desirable and the best policy will be the one with the greatest net benefits. Perhaps the best

policy will be rent regulation; perhaps it will be public housing, or shelter allowances, or an increase in the old age pension. It is hoped that if the focus is shifted at the outset away from the specific policy of rent review and onto the basic social values, some of the controversy that has clouded the debate can be avoided.

To offer a rationale for rent regulation, therefore, one must both identify society's values and analyse the effects of rent regulation regimes. Finally the two can be brought together so the effects can be judged according to the values.

The second section of the paper identifies six values that might form part of a rationale for rent regulation in Ontario: (i) everyone ought to have adequate housing; (ii) everyone ought to have affordable housing; (iii) everyone ought to have security of tenure; (iv) everyone has the right to the enjoyment of private property; (v) there ought to be an efficient allocation of resources in the economy; and (vi) there ought to be an equitable distribution of income. Sections 4 to 8 discuss each of those values in turn. Each section considers how to define the value, the extent to which it has been upheld in Ontario, and what government policies might make society better off according to the value.

Section 3 sets out the possible types of rent regulation and summarizes the effects of each. This material is drawn upon when subsequent sections assess the efficacy of rent regulation.

To ensure that as wide an audience as possible will find the paper readable, references to other

sources, especially academic articles, have been kept to a minimum and are contained largely in the notes collected at the end of the paper. All the main arguments and ideas are contained in the text: the notes are not necessary to an understanding of the paper.

2 THINKING ABOUT SOCIETY'S VALUES

The Commission of Inquiry into Residential Tenancies has been asked what reforms should be made to rent review in Ontario. It has been asked what ought to be done. Questions that deal with "should" and "ought" require what is sometimes called a normative approach. In order to decide what should be done, it is first necessary to have values (or norms) that enable us to say one situation is better than another. When we have those values, we can then say that a government should adopt a particular program because it will get us to the preferred situation. To decide how we ought to get somewhere, we must first know where we want to go.

Unfortunately, it is difficult, if not impossible, to discover precisely the collective values of society, because each of us has our own values and hence our own views of what ought to be done. From among the great diversity, how is one to choose the values to be used in thinking about rent regulation? Certainly philosophers have struggled for centuries to define what is good, and the controversy among them continues. Social science can be used to discover what values people hold and even why they hold them, but it cannot be used to choose the correct value. In Ontario, our system of government - including voters, interest groups, political parties, and the legislature itself - can be thought of as a system for developing, articulating and, through the passage of laws, acting on the

collective views of society.[1] A good place to start when thinking about society's values is with the public statements of government officials and agencies.

The Canadian Charter of Rights and Freedoms in the Constitution Act* of 1982 sets out the basic rights guaranteed under our constitution, but it contains no reference to housing. There are many, including the federal government, who have advocated that the right to the enjoyment of property be included with the right to life, liberty, and security of person in the list of fundamental rights that cannot be denied "except in accordance with the principles of fundamental justice." Several provinces have objected, fearing restrictions on their powers of land use zoning and of expropriation. Tenants' groups have also opposed the inclusion of property rights. The right to private property is protected under the Canadian Bill of Rights, but only in areas of federal jurisdiction, and the Bill can be overridden by other acts of Parliament. The Constitution Act also commits the federal and provincial governments "to promoting equal opportunities for the well-being of Canadians." There is no mention of rights to adequate consumption of such things as education, food, clothing, or housing. The emphasis is on equality of opportunity rather than equality of result.

The acts of the Government of Ontario that deal with housing or explicitly with rent review, such as the Ministry of Municipal Affairs and Housing Act, the Landlord and Tenant Act, and the Residential Tenancies Act** make no reference to the objectives of, or

* Canada Act, 1982 (U.K.), c. 11, Sch. B.

** The Ministry of Municipal Affairs and Housing Act, 1981, S.O., c. 19; the Landlord and Tenant Act, R.S.O. 1980, c. 232 as amended; the Residential Tenancies Act, 1979, R.S.O. 1980, c. 452.

rationale for, the acts. The first publication of the Ministry of Housing (Ontario, 1974) began with the statement: "Adequate housing at affordable prices is a basic right of all residents of Ontario." That is probably the most specific statement made by the Government of Ontario about society's fundamental values with respect to housing.

The publications of the Ontario Ministry of Housing that describe various housing programs often begin with a statement of the objective of the program. However, the objective is often no more than a statement of what the program does in a most mechanical sense. For example, the objective of a rental assistance program might be to increase the production of moderate-rent accommodation. Provided the program does not assist high-rent accommodation and is not offset by a decline in private rental starts, the program will meet its objective. But the statement provides no guidance about society's basic values and is of little assistance in choosing between alternative programs.

The list of society's values used in this paper is based on the sources cited above, on the academic[2] and popular literature dealing with rent regulation, on the hearings held by the Commission of Inquiry, and on background documents, prepared by the research staff of the Inquiry, that deal with the historical evolution of rent regulation in Ontario and the experience of rent regulation in other jurisdictions. The search of these sources revealed six values: (i) everyone in Ontario has the right to adequate housing, (ii) everyone in Ontario should have affordable housing, (iii) everyone in Ontario ought to have security of tenure, (iv) everyone in Ontario has the right to the enjoyment of

private property, (v) there ought to be an efficient allocation of resources in the Ontario economy, and (vi) there should be an equitable distribution of income in Ontario.

The survey of sources revealed, as might be expected, a great diversity of opinion as to the proper role of government in housing markets. There were also different opinions about what should be given up to achieve the value. For example, almost everyone agreed that Ontarians are entitled to adequate housing, but not all were willing to pay an infinite amount to ensure that everyone had adequate housing. The provision of adequate housing through a government program has an opportunity cost: that is, something will have to be given up to provide better housing. Society is better off if the opportunity cost is less than the value of the improved housing conditions. It is worth remembering that every government program has a cost and that people differ in what cost they regard as acceptable.

Another way of thinking about these values is to see them as definitions of housing problems. For example, a housing problem exists if people do not have adequate housing or if people do not have security of tenure. The objective of, or rationale for, government policies is to cure the problem. Rent regulation can be considered along with all other policies as a way to cure the problem. Thus the ideas of social values, housing problems, rationales, and objectives are all interrelated.

There are, of course, other values that govern the design and choice of government policies. Any policy ought to be understandable to the governed, give those

influenced by it due process and the right of appeal, and be responsive to criticism raised against it. It should be the least expensive way to achieve the desired result. But these values relate to the design of a program and assume that there is some rationale for the program in the first place. This paper tries to explore the basic rationales.

The survey of sources that produced the list of six values often encountered the statement "there ought to be no rent gouging" or "there ought to be no unconscionable rent increases". But "gouging" and "unconscionable" were never defined. This paper deals with rent gouging by emphasizing the relationship between rents and costs of production. A rent increase may reflect increases in costs of production, it may involve above-normal profits for a transitory period as the market adjusts, or it may involve above-normal profits more permanently when a landlord is exercising monopoly power. Depending on one's values, it is possible to label each kind of increase as gouging; however, most usage seems to refer to the second and particularly the third type of increase. This paper considers each type of increase and evaluates its effects on the six basic values.

3 RENT REGULATION AND ITS EFFECTS

Before turning to the discussion of each social value, it is useful to consider the different sorts of rent regulation and their effects.

Many different types of rent regulation are possible, and each can have different results. Even small differences in the regulations can substantially alter the outcome. As landlords are well aware,

whether a roof repair may be classified as an operating or a capital expense can influence the extent and timing of the repairs. And even the attitude of a rent review officer in applying the regulations can influence the rent that is established. The details of any regulatory regime are vital to understanding the effects of that regime. However, a paper such as this cannot analyse small differences between alternative forms of rent regulation. What is required is a more aggregate, stylized characterization.

Broadly speaking, rent regulation regimes can be described according to three characteristics: their coverage, whether they are expected to be permanant or temporary, and how the allowable rent is established.

The coverage of rent regulation may be complete or may permit exemptions. What are sometimes called first-generation rent controls cover all residential tenancies; second-generation controls provide for certain exemptions, such as new buildings, units that have undergone a major renovation, rooming houses, units in buildings with fewer than a certain number of units, or units where the tenant shares the kitchen or bathroom with the landlord. Sometimes a unit becomes exempt when it is vacated. Other regimes exempt units that rent for more than a specified amount or units that are already publicly subsidized. Obviously the possibilities are limitless. The critical distinction is that, when exemptions are allowed, two different rental markets exist - the controlled and the uncontrolled.

A second fundamental feature of a rent regulation regime is whether it is expected to be permanent or temporary. Under a permanent regime, controls are

expected to remain in effect forever; under a temporary regime, the controls are gradually lifted by letting rents rise or by gradually exempting more and more units until none are controlled. A system of temporary regulation alters the path of rent adjustment over time but permits rents in the long run to be what they would have been in the absence of regulation.[3] For example, suppose there were a large unanticipated increase in demand (perhaps due to an increase in migration to a housing market); or suppose there were an interruption in the supply of rental housing while demand continued to increase (perhaps because there was a war and resources were being devoted to other uses, or perhaps because a municipal government changed its policies and restricted the servicing of land or reduced the density permitted on redeveloped land); or suppose a particular residential district in a city suddenly became popular.[4] In all of those cases, rents would probably rise sharply. Depending on the case and the responsiveness of new supply to higher rents, the market rent may return to its original equilibrium level as in Figure 1, or it may settle at a new, higher equilibrium level, as in Figure 2. A rent regulation system could alter the adjustment path; this is illustrated for a hypothetical system by the dotted lines in the two figures. Both first- and second-generation controls can be either permanent or temporary. Some systems with exemptions imply that the controls are not permanent: for example, the exemption of new units or of units with very high rents will in the long run remove all units from control. But that would be the very long run when "we are all dead." Obviously it is a matter of degree whether controls with exemptions are considered permanent or temporary. Regimes with new-unit exemptions should probably be thought of as

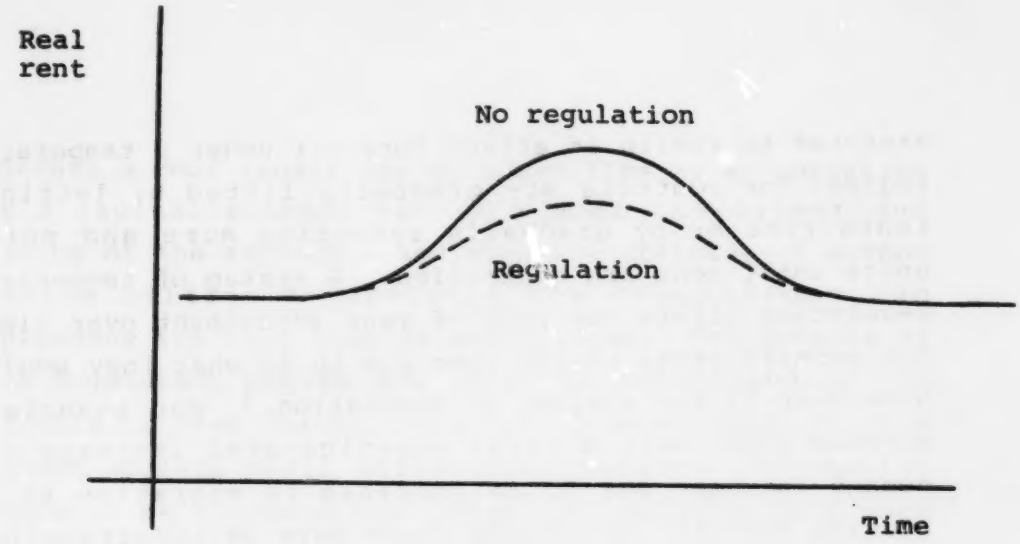

Figure 1: Hypothetical Paths of Rent Adjustment
No Change in Long-Run Rent

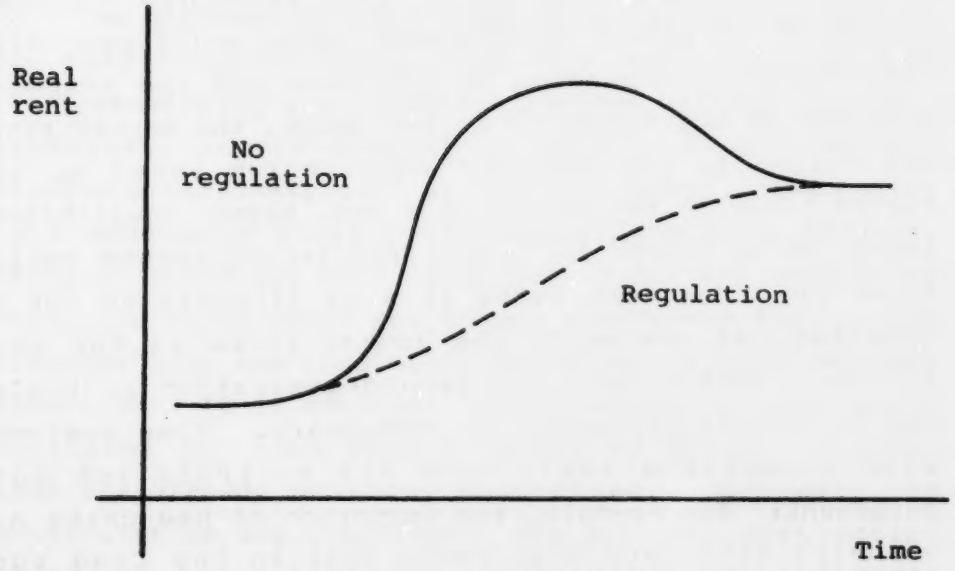

Figure 2: Hypothetical Paths of Rent Adjustment
to a Higher Long-Run Rent

permanent, while regimes with a decontrol at the first change of tenants could be considered temporary.

An important sub-classification of permanent control regimes is into those that control rents at all times and those that regulate rents only at certain times. Several examples in the latter group will illustrate the distinction. A permanent control regime might be designed to alter the adjustment path of rents, as in Figure 1 and 2, whenever there were abrupt changes in rents; but whenever rents changed slowly there would be no administrative involvement in the establishment of rents. Rent increases above, but not below, a certain percentage might be subject to regulation. Another kind of permanent rent control exempts units when they become vacant or when the tenant changes but regulates rents during a tenancy.

The third characteristic of rent regulation is the means by which the allowable rent is established. There are many possibilities, including a rent or rent increase that is set by law (or an administrative agency) for all units regardless of their particular details; a cost-pass-through system under which the nominal profit of a landlord would be fixed but all cost increases compensated; or a system that sets rents to allow landlords a certain rate of return on their investment. The second and third characteristics of rent regulation regimes are closely related: the allowed rent increase can influence whether rents are reduced permanently or only during a transition period. In principle, however, each type of rent-setting mechanism could be either permanent or temporary. Obviously, the allowed rent will determine how much rents are held down and therefore how binding the controls are. What is important here is, not how much

rents are held down, but what sort of issues enter the rent determination process.

The current system of rent regulation in Ontario is a regime with exemptions; it is permanent and controls rents at all times; and it sets rents according to a cost-pass-through procedure.[5] There are numerous detailed descriptions of the system of rent regulation in Ontario.[6]

The above description of rent regulation attempts to separate the definitions of various types of rent regulation from the effects. The type of rent regulation should be discernable by reading the legislation; the effects, however, must be discovered through economic analysis and empirical work.

The primary effect of rent regulation is on the rental price of controlled housing units. Any analysis must begin by comparing controlled rents with what the rents would have been if there had been no controls. Once the direction and magnitude of the effect on controlled rents is established, then all the other effects - on maintenance, on conversions, on new starts, on people's housing conditions, and so on - can be analysed. But all those other effects hinge on how much rents have been kept down. If rents are not changed, because the controls are not binding or enforcement is lax or tenants make side payments to landlords equal to the rent reduction, then the other effects will be insignificant. If rents are kept down only a little, then the other effects will probably be small.[7]

Inevitably, it is very difficult to establish what rents would have been in the absence of controls.

Consider, for example, the case of the Toronto housing market. One approach is to find another housing market that is identical to the Toronto market in every significant respect except that it does not have rent regulation. Then any differences between the two markets can be attributed to rent regulation. In order to be sure that the two markets are similar in "every significant respect," you must know how rents are determined. If you believe that rents are established at the level where the demand for housing equals the supply, then you must be sure that all factors determining demand, such as number of people and household income, and all factors determining supply are the same in the two markets. Or if you believe that rents are set by the greediness of landlords, then you must be sure that landlords are equally greedy in the two markets.

Another approach is to specify and estimate a mathematical model of the Toronto housing market. The model can be used to simulate the market in order to see what rents, and also new starts and housing conditions, would have been in the absence of controls. The results can then be compared with the actual rents, starts, and housing conditions and the difference attributed to rent regulation.

There are obvious problems with both approaches. There is no housing market similar to the Toronto market in all significant respects except rent regulation. Nor is there a mathematical model of the Toronto housing market to use for simulation purposes and, even if there were, it could be argued that the structure of the market has changed since the introduction of rent review so that the model could not be used to simulate the current era. Nevertheless, any

ad hoc attempts to describe the effects of rent control implicitly use one of the two approaches. Statements such as "when controls came off in Edmonton, rents rose by x per cent" or "look at what happened in New York under rent controls" are based implicitly on the first approach; while statements such as "in the past rents rose at x per cent of the rate of growth of the consumer price index, so rents would have risen y per cent in the absence of controls" are based implicitly on the second approach. These ad hoc attempts are bound to be controversial and should be regarded with caution; one should always refer back to the analytic framework of the first or second approach to see what bias the ad hoc logic has introduced. Nevertheless, these attempts may be the best we can do, and they can contribute to our understanding if used carefully.

There is a third approach, and that is to use economic theory to analyse the effect of rent regulation in the abstract. For example, suppose a system of rent regulation reduces rents below what they would have been. According to economic theory, there will be excess demand for rental units at the controlled rent. This is because households will want to consume more housing at the lower price and landlords will want to supply less housing (there will still be excess demand, even if the rent regulation successfully compels the landlord to supply the same amount of housing). Vacancy rates will fall. Some households, unable to obtain a controlled rental unit, will have an incentive to make a side payment to a landlord to obtain a controlled unit (the household is better off making a side payment and paying the lower controlled rent than under its current living arrangement). The economic analysis could be extended to predict the number and amount of payments by

assuming certain elasticities (the responsiveness of demand and supply to changes in rent) and by assuming certain characteristics of landlords and tenants.

This last point is important. Under very general and acceptable assumptions, economic analysis can predict the direction of the effects of rent regulation with considerable accuracy. When more assumptions about elasticities and so on are added, economic theory can also predict the magnitude of the change, but such predictions are more speculative. However, without any assumptions about elasticities, a useful rule of thumb for the magnitude of changes would be that the more the rent regulation holds rents down, the larger the other effects will be. Although the rule is rather obvious, it is often forgotten in the public debate. Opponents of controls claim that there will be a drastic effect on the new supply of housing and on the property rights of landlords; proponents of controls claim they are absolutely vital to the well-being of tenants. Yet many rent control regimes have little effect on rents and so the other effects are also likely to be slight.

The rest of this section summarizes the effects of rent regulation by using the third approach: i.e., it uses economic analysis to predict the direction of changes and the rough rule that the magnitude of change is proportional to how binding the controls are.

While the third approach may at first seem to rely excessively on abstract theory, it does so no more than the others. The only difference is that it is explicit, which is of benefit. To use the first approach one needs economic theory in order to determine what variables to hold constant between markets; to use the second, economic theory is necessary in order to design

and estimate the simulation model; and to use even an ad hoc approach requires an implicit theoretical model on which to base the logic of the argument. Some people are sceptical of the third approach because they have found no strong evidence to support the predictions of economic theory - for example, that side payments will be made - and as a result have rejected economic analysis. Often, however, there are reasons for the lack of evidence. Sometimes the problem is that data do not exist for testing the prediction or that changes are so small that one cannot test the prediction about the direction of changes. Of course predictions of economic analysis must face empirical testing. But critics who would reject the predictions of economic analysis must provide an alternative theory of how housing markets operate and how the predictions would differ.

A good starting point[8] in thinking about the effects of rent regulation is to consider a system of permanent controls with universal coverage that is binding at all times (i.e., rents are kept below their level without controls, which is assumed to reflect costs of production, including a normal rate of return). Assume that the regulations do actually set the price per unit of housing service.[9] The immediate result is that existing tenants pay less for their housing and landlords receive less. There will be no new construction because rents are below production costs (defined to include a normal return). Over time the original housing stock will diminish. Buildings will be allowed to depreciate more quickly or will be converted to condominiums or to non-residential uses or will be demolished so that the land can be used for other purposes. The contraction of supply will stop when the controlled rent just permits the owners of the

remaining buildings to cover their costs. This can occur if the contraction reduces costs on the remaining buildings or if landlords differ in efficiency and the less efficient producers depart, leaving those who can earn a normal return at the regulated rent. If one of those things does not occur, the contraction will continue until there is none of the original stock left. At first glance, this prediction seems extreme, but on reflection it is self-evident: if a price is set below the cost of production, nothing will be supplied in the long run.

Let us suppose, however, that the contraction does stop. Then tenants will pay less than they would without regulation, landlords will receive less but will be earning a normal rate of return (because costs have fallen), the stock of rental housing will be less, and there will be excess demand at the controlled rent. All landlords will suffer capital losses in their capacity as landowners. In the long run, the effects of controls lead to lower land values.[10] Vacancy rates will be lower, the cost (especially the time cost) of searching for a new apartment will be higher, the rate of household formation will be lower, and mobility will be less. There will be a mismatch between tenants and dwelling units. There will be a tendency for tenants who want a different controlled unit to bribe the landlord or a sitting tenant to acquire it. The benefits accrue unequally to tenants: those who would not have moved enjoy the largest gain, while those who would have moved may suffer a net loss. There will be a reduction in the total taxes collected from landlords, but that will be largely offset by the increased taxes collected from the sectors where people choose to spend the extra money they have because rents are held down. The housing stock is less, but output

in other sectors is higher. Resources will be used to police and administer the system, and tenants will use resources to make sure the regulations remain while landlords will use resources to try to get the regulations removed.

Those are the effects predicted by economic analysis of a system of permanent controls with universal coverage that are binding at all times. It should be remembered that the predictions deal with the direction but not magnitude of the effect. Those predictions are supported by an enormous body of empirical evidence from controls in housing markets as well as in other types of markets.

However, most current systems of rent regulation are not the permanent, universal, binding regulations outlined above; rather, they are permanent and binding but provide exemptions for new construction and major renovation. The exemptions are intended to reduce the contraction of the housing stock caused by rent controls. In these cases there are two rental markets: a controlled and an uncontrolled market. The effects on the controlled market have already been described: tenants pay less, landlords receive less, and the supply is contracted through reduced maintenance and increased conversions and demolitions. In the uncontrolled market, rents are higher than in the controlled market - just how much higher depends on the demand for, and supply of, new and renovated rental units. The demand depends upon how much excess demand spills over out of the controlled market into the uncontrolled market (this overspill is strongly influenced by how quickly the controlled stock contracts). The uncontrolled market will tend to include households that have just moved to the city,

households that have just been set up, households that had a strong reason to move, or households that are selling their houses and want to rent. "Undesirable" tenants, such as young people or large families will tend to be excluded from the controlled sector. The supply of uncontrolled units depends upon the normal technological and cost factors that determine supply and on how much new suppliers believe that in the future controls will be extended to units previously exempt. The more the suppliers believe this, the higher the initial rent needed to justify new construction. The risk of subsequent control means that a higher rate of return is needed to attract capital into the industry. On balance it is likely that rents in the uncontrolled sector will be higher than in the controlled sector and that rents in the urcontrolled sector will be higher than rents would have been in the absence of controls. New construction and renovation will probably be less than in the absence of controls. But the total housing stock is greater under controls with exemptions than under controls without exemptions.[11] Under rent regulation with exemptions, some tenants pay less for housing and some pay more: the pattern of benefit is made more unequal.

Sometimes rent control regimes contain provisions intended to reduce the contraction of the controlled stock: restrictions are placed on conversion to condominiums, on conversion to non-residential uses, and on demolition, whether the replacement building is residential or not. Again, resources will be used to police and administer the restrictions, tenants will use resources to ensure the restrictions remain, and landlords will use resources to try to remove the restrictions. There will tend to be side payments between tenants and landlords to stop conversion or

demolition. Sometimes rent regulations also provide for reduction in rents if maintenance levels are reduced. The purpose is to ensure that the price per standardized unit of housing service is regulated. If the landlord reduces maintenance, thereby reducing the number of standardized units of service provided by the dwelling, the gross rent must fall, given a regulated price per standard unit. If only the gross rent per dwelling were controlled and landlords could reduce maintenance and thus the number of standardized units of service provided, then in effect the price per standardized unit of service would rise.[12] Even with the maintenance adjustment provisions, landlords will tend to reduce maintenance below the level that would have prevailed in the absence of controls (until the contraction of controlled stock is complete), since the money they were previously spending on maintenance will have a higher rate of return elsewhere.[13] The result is likely to be a demand for regulations to set compulsory maintenance levels.

Rent regulation is thus a good example of the effect of price controls in a market economy. When a price is held below the cost of production, the quantity supplied diminishes. And as each cause of reduced supply comes to light, there is pressure on the government to intervene. At first, the solution is to exempt new construction and renovation. Then the contraction of the existing rental stock is restricted by zoning bylaws and controls on conversion or demolition. Next come maintenance controls. Regulations often beget more regulations.

Controls of the two types just discussed - permanent, universal, and permanent with exemptions -

are by far the most common. The other types can be dealt with briefly.

Temporary binding regulation, with or without exemptions, alters the adjustment path of rents but not the long-run level. During the period when adjustment is affected, the results discussed above apply, but in the long run the influence of controls is minimal.

Another form of regulation is permanent but not binding at all times (exemptions are possible but not usual). If a sudden unanticipated change in costs or demand would raise rents significantly in an unregulated market, the regulations alter the path of adjustment; but the regulated rents allow the landlord a normal rate of return, so that over time the rents return to what they would be in the absence of controls. Under a variant of this general type of regulation, units become decontrolled when tenants leave but return to the controlled sector when new tenants enter. Major rent adjustments occur between tenants. When controls of this kind are binding, they have the effects already discussed. However, although they are not binding at all times, they will increase the long-run rent per standardized unit of housing service. They redistribute from landlord to tenant some of the gains that would accrue to existing landlords when the market price rises in response to an unanticipated change. Thus the long-run rent necessary to attract new supply will have to be higher (because without such a change the rate of return to investment in rental residential real estate would fall below the return it would realize elsewhere). The gains from unexpected rent increases are reduced, but the losses from unexpected cost increases or rent declines are still borne by the landlord.

Our detour into the types of rent regulation and the effects of rent regulation is complete. We can now return to a discussion of society's basic values. The following sections will define each value and, using the foregoing examination of the effects of rent regulation, will analyse the different forms of rent regulation to see which of them make society better off according to the value in question and whether alternative policies might better achieve the desired result.

4 ADEQUATE HOUSING

The first item on the list of society's values was that all people are entitled to adequate housing. Most of us have a good idea of what adequate housing means, although a precise definition is probably impossible. We recognize that the definition will be different at different times, in different countries, and perhaps in different regions of a country. Nevertheless, we have a sense that everyone in Ontario, regardless of their income or race or whether they are employed or unemployed, should have housing that is clean, dry, properly heated, and in a good state of repair; that has hot and cold running water and indoor plumbing; and that is not overcrowded.

It is more difficult to devise an operational definition and to gather data on who does and who does not have adequate housing in Ontario. The best sources of data are national surveys by Statistics Canada such as the census, the Survey of Consumer Financies, Family Expenditure in Canada, and Household Facilities and Equipment; and Canada Mortgage and Housing Corporation's Survey of Housing Units. This is not the place to describe and analyse all the information contained

there, but the main conclusions can be summarized. Data on whether a dwelling unit is clean or dry or in need of repair are either not available or unreliable. The best measures - perhaps "proxy" measures would be a better term - of whether a household has decent housing is to establish whether their dwelling unit has hot and cold running water, central or electric heating, and exclusive use of a flush toilet; and whether the household is overcrowded (more than one person per room is the usual standard assumed). On the basis of these measures, between 5 and 10 per cent of households do not have adequate housing (it is probably closer to 5 than 10 per cent).[14] There has been dramatic improvement in the housing conditions of Ontarians over the last thirty years, and now the vast majority of people have adequate housing and indeed are well housed. Those who do not have adequate housing tend to be poor and often unemployed or retired; sometimes they are elderly people, sometimes young transients in large cities; they sometimes live in rural areas or are native people or former psychiatric patients. But no summary is very meaningful - they are a very heterogeneous group. Although only a small percentage of the population, the absolute number of people without adequate housing is large and their plight deserves redress.

It is sometimes argued that rent regulation helps to ensure that the poor get adequate housing or that at the very least more people are able to get adequate housing. At first glance that argument has a certain appealing logic. Most of those who do not have adequate shelter are renters, and rent regulation holds rents below what they otherwise would be, with the result that renters can buy better housing because of the lower price. The conclusion, however, is wrong

because it foregets that, to the extent regulation reduces rents, it provides incentives to reduce the supply below what it otherwise would have been. There can be disagreement about how much the supply has been reduced, but surely no one can argue that the supply remains unchanged or increases. Because the supply decreases, rent regulation cannot ensure that people are better housed in aggregate, although some will be able to take advantage of the lower rent to get better housing. And there is little reason to suppose that the poor as a group, or those who are now inadequately housed, will get a bigger share of the smaller pie under rent regulation. The opposite is probably true. When there is excess demand for rental housing, landlords can discriminate more easily when they choose their tenants. The disadvantaged probably fare worse under such a rationing system than under a market system. Some lucky households will be able to find a vacant dwelling in the controlled market and improve their housing conditions under rent regulation. But in the long run, rent regulation means that fewer, not more, households have adequate shelter. To the extent, of course, that the effects of regulation on the quantity supplied are mitigated, that undesirable result will be mitigated. However, rent controls with exemptions usually cause uncontrolled rents to be higher than rents in the absence of controls, so that any household forced into the uncontrolled market will, of necessity, consume less housing.

Thus the right to adequate housing is not a justification for rent regulation. In fact, it provides a rationale for not using rent regulation. Any policy intended to ensure that people have adequate shelter by reducing the price to the consumer must sever the link between the price paid by the consumer

and the price received by the landlord. A cash subsidy to assist with housing expenses, such as a shelter allowance, does just that. It increases the demand and hence the market rent per unit of housing service. Landlords get more per unit, the quantity supplied is increased, and the after-subsidy price to the household decreases with the result that they can consume more housing. Public housing also does that, although the public sector provides the new supply. Clearly there are better ways than rent regulation to ensure people have adequate shelter.

5 AFFORDABLE HOUSING

The second of society's values on the list was that everyone is entitled to affordable housing. Despite its frequent mention in public discussion, in the housing literature, and in numerous government studies, the concept is elusive. On reflection, it appears that affordability of housing is not itself a fundamental social value but rather a proxy for several fundamental values - that people are entitled not only to adequate housing but also to adequate medical care, clothing, food, education, and so on. However, it is a poor proxy and its use leads to poor policies. The logic behind this conclusion is set out below.[15]

What precisely is meant by affordable housing? How can it be defined so that one can establish whether housing in Ontario is affordable? Or phrased in a different way - who in Ontario is suffering from a housing affordability problem? It should be remembered that this concept does not relate to adequate housing, which has already been dealt with. For the affordability concept to be meaningful, it must identify a problem that exists even when people have adequate

housing. According to literature on housing, affordability problems exist if a household spends more than some percentage of its income (usually set at 25 or 30 per cent) on housing.[16] But why is it a social problem if someone spends more than 25 per cent of their income on housing? Surely we do not hold as a fundamental social value that all households ought to divide their expenditure in such a way that they do not spend more than 25 per cent of their income on housing? If a young professional couple with a household income of $70,000 buys its first home - a renovated townhouse in downtown Toronto - and spends more than 25 per cent of its income on housing, that is not a housing problem nor does it conflict with any fundamental social value. Similarly, if a lower-income family spending more than 25 per cent of its income on housing were to move to a smaller apartment and spend the money saved on other things, thereby reducing the percentage of its income spent on housing below 25 per cent, it cannot be argued that housing problems are reduced or that society is somehow better off. There is obviously something more at issue when people discuss housing affordability than the percentage of income spent on housing.

The first restriction that must be placed on the use of the measure is that it can apply only to lower-income households. If a high-income household spends more than 25 per cent of its income on rent, it is not a social problem. However, if a lower-income household spends more than 25 per cent, it is a social problem. This restriction draws out the logic implicit in the concept of affordability. If a lower-income household spends more than 25 per cent of its income on housing, then there will not be enough money left over to buy sufficient food, clothing, transportation, recreation, medical care, education, and so on; there

is a social problem because society holds that everyone is entitled to adequate amounts of those things. The underlined words are usually omitted, but in fact, housing affordability is being used as a proxy to measure the inadequate consumption of other goods.

One can understand how the concept emerged. Housing analysts studied the data to see which households did not have decent housing. As has been pointed out, the percentage of households with inadequate housing has been falling and is now rather low. Yet the statistics seemed to miss some essential aspect of reality. In order to survive the Ontario weather, one must spend a considerable amount to secure decent shelter. Low-income households might therefore have decent housing - they have to - but to say they had decent housing did not reflect their well-being. They had obtained housing but had been unable to secure the other necessities. Out of this emerged the housing affordability concept and the 25 per cent rule.

For many reasons, however, the concept and rule are a poor proxy for the under-consumption of other things. The implicit logic should dictate that the percentage of income spent on rent that is used to identify a problem of under-consumption would fall as income falls. Suppose the other necessities cost $4,500 a year for a household. Then if a household with an income of $5,000 spends more than $500 on housing (i.e., 10 per cent of its income), it would not consume enough other things. If a household with an income of $4,501 spent more than $1 on housing, it would under-consume other things. The 25 per cent rule should also vary as the relative price of housing changes. There seems to be a widespread belief that the relative price of rental housing has risen,

although it has actually fallen over the last twenty years.[17] As the relative price falls, the percentage in the rule should fall. The rule also does not recognize that people's preferences for housing differ, that in cities the percentage of income spent on housing among similar people will vary depending on how they trade off housing consumption and commuting costs, and that over a lifetime the percentage of income spent on housing will vary: it will be high among the elderly because income is low and because housing and leisure are consumed together. But most important of all, it is a poor proxy because it diverts attention from the fundamental underlying social values - namely that all households are entitled both to adequate housing and to adequate consumption of other things.[18] It leads one to treat the situation as a housing issue when it is actually much broader.

The first step in a proper analysis should be to define what the social entitlements are on all commodities, including housing. Then there should be documentation of who in Ontario does not have those commodities. People base their consumption levels on their preferences and incomes and on prices. Alternative policies to ensure that all consume adequate amounts include such things as income transfers, job training programs, assistance with family budgeting, direct provision of goods, and price reductions on the various necessities. Any price reduction program should be aimed at those who currently under-consume and be designed so that the price received by the producer is not reduced (so new supply will be forthcoming).

The concept of affordable housing itself is not a fundamental social value and should not be used in

considering the rationale for rent regulation or in assessing the effect of rent regulation. The fundamental values are that people are entitled to adequate amounts of other necessities such as food, clothing, and so on. Admittedly, rent regulation, by lowering rents, does permit low-income households to consume more of the other necessities and that is a desirable outcome, given society's value system. But there are far better ways to achieve the same result, since, under rent regulation, most of the increase in other consumption is by renters who already consumed adequate amounts of non-housing items.

6 SECURITY OF TENURE AND PROPERTY RIGHTS

The values of security of tenure and the right to private property are considered together here because they are often two sides of the same coin. To increase the security of tenure of a tenant usually entails a restriction of the property rights of a landlord. Rent regulation is sometimes justified as a policy to increase the security of tenure of tenants. Regulation is certainly never rationalized because of its effects on property rights, but because these effects are significant and because the right to private property is a widely held value, they must be included in a comprehensive analysis of rent regulation.

Let us begin the discussion of security of tenure in the same way as the other values have been explored - by defining it and seeing who does not have it in Ontario. What is security of tenure and how secure is the tenure of tenants in Ontario? Absolute security would imply that a tenant could remain in an apartment so long as they chose to do so, but it goes beyond that. Suppose the income of a tenant were to fall, the

tenant might then choose to move to a smaller apartment because they would prefer to spend less on housing because of their smaller income. That is a legitimate use of the word "choose." Yet some would argue that the tenant was forced to move and did not enjoy security of tenure. The same applies to a rise in rent on a dwelling. The tenant might choose to move, but some would say they were forced to move. If, however, the tenant's income rose or the rent fell, then a tenant might also choose to move and yet no one would argue that they had been forced to. The idea of absolute security of tenure therefore means that a tenant would be protected against any fall in income or any increase in the market rent that would cause them to leave the apartment and, moreover, that the landlord could not, on any grounds, refuse to continue the rental. The landlord might wish not to renew a tenancy for frivolous or malicious reasons; because of discrimination; because the tenant was bothering other tenants; or because the landlord wished to renovate the unit, live in it himself, convert it to other uses, or demolish it. In the extreme, absolute security would mean that the tenant could remain even if the rent were not paid. Absolute security exists if you have all rights of ownership and no costs to exercising these rights. It seems fairly clear that society would not desire all tenants to have absolute security of tenure.

On the other side is the landlord, the owner of the apartment unit. Full private property rights would entitle the landlord to use the unit as he sees fit and to enjoy the full benefits of use of the unit. If the landlord were to rent the unit, the tenant would have the right to use and enjoy the unit only insofar as these rights were agreed to in a contract with the landlord. In Ontario, landlords do not have full

private property rights, for there are zoning and occupancy standards governing the use of the land and building, and income taxes take some of the benefits of use of the unit. Furthermore, the landlord cannot refuse to rent or renew a rental for frivolous or malicious reasons or because of discrimination. But the landlord can terminate a rental, with proper notice, if the tenant is bothering others or has not paid the rent, or if he wishes to renovate, convert, or demolish a unit or live in it himself.

Each restriction on the property rights of the landlord increases the security of tenure of the tenant. Clearly the agreement to rent an apartment is different from many rental agreements. An apartment is the home of the tenant and to change homes can often be an expensive and painful disruption. Society has accepted the increase in tenants' security at the expense of restricted property rights, although the shift is recent and has not gone very far.[19] Tenants must still pay the rent that the landlord establishes (which presumably will be near the market rent), and a rental can be terminated by the landlord for the reasons noted above. Tenants may also be forced to (choose to) leave because their income has declined or the rent has risen. In extreme cases, the landlord may raise the rent above the market rent to cause a tenant to leave.

It has been suggested that rent regulation should be used to provide increased security of tenure for tenants. Before deciding whether rent regulation will have that result, it is useful to ask how secure tenants are at present. Unfortunately there is almost no evidence available. On average, tenants' incomes have risen faster than rents, so that while a potential

insecurity exists, in fact, tenants on average have not had to leave their apartments because of falling incomes or rising rents. Over a lifetime, people's incomes first rise and then decline during the retirement years, when they often move to a small apartment. That is to be expected, and it is unlikely that society wishes to ensure that people can remain in the dwelling they occupied at the height of their life-cycle earnings. (That assumes that the household can still have adequate housing; but if it cannot, that is an issue of adequate housing, not security of tenure.) Some households have had to leave their apartments because of declines in their incomes or increases in the rents of their units.[20] There are no data that show how many have had to. Another common cause of a tenant having to leave is that the landlord wishes to renovate, convert, demolish, or live in a unit, but again no evidence is available on how often that occurs.

It is interesting to compare the security of tenure of tenants and homeowners. Homeowners, especially ones with mortgages, also face insecurity because of changes in incomes and prices. Over the last decade of high and unpredictable mortgage interest rates and of mortgages with a short term, homeowners with large mortgages have probably been less secure than tenants with respect to income and price changes. On the other hand, homeowners do not have the insecurity of someone else deciding to renovate, convert, demolish, or live in their house.

The rationale for rent regulation as a means of increasing tenants' security of tenure is that, by preventing sharp rent increases, it will enable tenants

to remain who otherwise would have been forced (chosen) to leave their rented dwellings.

Security of tenure in that sense would be increased by a permanent, binding system of rent regulation, with or without exemptions. A temporary system or a permanent system binding at some periods would not remove the insecurity, but it would allow a longer period of adjustment for the tenant because rents would change more slowly. It is unclear, however, by how much security would be increased, because we do not know how many tenants would have had to leave in the absence of controls.[21] The main effect is that tenants who would not have moved anyway in the face of the price rise have more money to spend on other things.

It is interesting to compare rent regulation with the way governments dealt with the homeowner's insecurity caused by having to renew mortgages at high rates. In the early 1980's, it was alleged that many households would lose their homes because of the high interest rates. Under the Canada Mortgage Renewal Plan, mortgage lenders were not required to continue their loans at the old low rates, a requirement that would be analogous to rent regulation. Instead the federal government offered homeowners financial assistance financed by all taxpayers, thereby imposing the cost of the increased security of tenure on all taxpayers rather than on a small group, as is the case in rent regulation. And finally, the assistance was not available to all homeowners renewing mortgages but only to those households that would have to pay more than 30 per cent of their income on mortgage payments; again in contrast, rent regulation is universal, not targeted. In the end, it proved that despite an enormous outcry that thousands would lose their homes - a far higher

prediction than is ever heard about tenants' insecurity - few households took advantage of the program. Recognizing that mortgage payments were going to rise, they had arranged their finances accordingly.

The treatment of homeowners is an illuminating contrast that points out the weakness in using rent regulation to reduce insecurity of tenure caused by the possibility of large rent increases. Rent regulation imposes the cost of the increase in security on the landlords of existing controlled buildings. The regulation provides insurance against inflation and a change in the relative price of a rental dwelling (if there were no inflation or no change in relative prices, there would be no insecurity of this sort). But the tenant does not pay the insurance premium: the landlord does. If that sort of insurance were desired, it could easily be accommodated in a lease, but the rent would reflect the insurance premium. However, if society wishes to provide tenants with insurance, surely it is more equitable that all of society share the burden of providing it. Furthermore, rent regulation does far more than ensure that tenants who would otherwise have been forced to move can remain. It also protects tenants who would otherwise have remained in their apartment against having to rearrange their finances to spend more on housing. It makes sure that tenants can spend on other things. This sort of security is not a widely held value.

While providing security of tenure by limiting unanticipated price increases, rent regulation reduces security of tenure in other ways. By reducing the rent, a universal permanent system, with or without exemptions, results in controlled landlords being more likely to demolish or convert a dwelling unit and

consequently reduces the amount of housing available. Thus rent regulation results in increased insecurity of another sort. And the more rents are held down and price insecurity is reduced, the more the insecurity due to conversion and demolition increases. It is not clear whether there will be a net increase or decrease in security of tenure.[22]

The best balance between the two results could be achieved by a system of controls that altered the adjustment path of rents but not the long-run level (except for the slight upward movement since this type of control usually applies to the entire stock and is permanent). Tenants would be protected against sharp, extraordinary increases but not against finally having to adjust to inflation or a long-run relative price change on their unit. If only the adjustment path of rents is altered, there is little increase in the incentive to demolish or convert.

7 PARETO EFFICIENCY

The word efficiency is widely used and understood. It means getting more output from what you have or using fewer inputs to produce the same output. To be efficient is to imply that there is nothing wasted, and that is desirable. The words efficiency or economic efficiency are also used in economic analysis, but their meaning goes beyond their meaning in everyday usage. For that reason, the term "Pareto efficiency" rather than "economic efficiency" is used in the discussion below.[23]

The economy is said to be Pareto efficient if there is no reallocation of resources possible that can make some people better off and leave nobody worse off.

To pursue Pareto efficiency is, therefore, to recommend changes that help some people and hurt no one. Assuming that people care about their absolute well-being (rather than their well-being in relation to other people), then changes recommended by the Pareto efficiency criterion would receive unanimous approval. An argument that a program is desirable because it will result in Pareto efficiency is based on an assumed social value, just as much as an argument that a program is desirable because it will result in increased security of tenure. Both arguments depend upon social values. Economists have tried to reduce the importance of assumed values in their analysis. Many base their recommendations solely on the Pareto efficiency value because they believe this value is not controversial[24] and would be universally acceptable (in the sense indicated above). However, few programs would help some people and hurt no one; and clearly there are some changes that can help some people and hurt others but on balance leave society better off. Rather than try to make interpersonal comparisons and try to weigh the relative deservedness of the gainers and losers, many economists recommend "potential Pareto improvements." There is a potential Pareto improvement if the gainers could compensate the losers and still be better off; therefore, the change could, in principle, help some people and hurt no one. That is the logic underlying cost-benefit analysis. However, the compensation will not occur automatically. Consequently, when a program is recommended on the grounds that it will yield a potential Pareto improvement, it is recognized that the government's role will not stop with the program: there may have to be a compensating redistribution of income. Thus the final choice of a program cannot be made on the basis of Pareto

efficiency alone but on the basis of efficiency and equity combined.

The next step in using the Pareto efficiency value is to apply a group of theorems in economic theory that demonstrate that an economy in which there is no government intervention will yield a Pareto efficient allocation of resources, provided a list of other conditions hold. The theorems are the formalization of Adam Smith's invisible hand argument. An economy without government intervention is desirable because it will achieve Pareto efficiency, which is an accepted social value. That is the essence of the view of many conservative (in philosophical terms, classical liberal) economists, and it often arises in the debate about rent regulation. But the list of conditions that must hold is long and restrictive: households and firms must act competitively and take prices as given; there must be no externalities or public goods; households and firms must be equally and fully informed; there must be no transactions costs.

If one or several of those conditions does not hold, then it cannot be shown that the laissez-faire economy is Pareto efficient. If one of the conditions does not hold, there is the potential for a government program to be a Pareto improvement. Each condition offers a possible reason for government intervention. (Of course the framework also allows governments to intervene to deal with what can be broadly termed equity: adequate housing, adequate consumption of other necessities, security of tenure, and income distribution).

The use of the Pareto criterion as a rationale for government intervention can be further clarified

through two examples familiar to most readers. The economists' opposition to monopoly is based on the reasoning that resources will not be Pareto efficiently allocated if a monopoly exists. A monopolist will restrict output compared to a Pareto efficient (competitive) world. If resources could be moved into the monopoly sector and away from other sectors of the economy, the increased output of the monopoly sector would have greater value than what has been given up elsewhere - that is, a potential Pareto improvement would be possible. Similarly, externalities can result in a non-Pareto efficient allocation of resources. This is the basis of an economic argument against pollution. If the polluting industry reduced its output and its level of pollution (freeing its inputs to go elsewhere), the value of the reduced damage from pollution and increased output elsewhere would be greater than the value of the lost output of the polluting industry. Again a Pareto improvement is possible.

We can now inquire whether the Ontario economy is Pareto efficient, and, if it is not, what policies might achieve Pareto efficiency. First we must see whether each of the conditions necessary for a private economy to be Pareto efficient exists in Ontario. It is immediately obvious that, strictly speaking, none of them holds. Often, however, the condition holds approximately, or when it does not hold, there is no government program that can yield a Pareto improvement. There have been several studies[25] applying the Pareto efficiency criterion to the Canadian and Ontario housing situation. They have concluded that there are several cases where government intervention (or maintaining the current intervention) might yield a Pareto improvement. But in most cases, rent regulation

is not called for. Those cases will not be discussed here. Instead, the emphasis will be on the cases where rent regulation might be the policy to yield a Pareto improvement.

If market rents are subject to wide fluctuations or if there are sudden unanticipated changes in the relative price of housing, it may yield a Pareto improvement to intervene and reduce the fluctuations or to alter the adjustment path of rents. The words "may yield" must be emphasized, because economic theories on this matter are in their earliest stages and very speculative. Little is known about the efficient rate of adjustment. Even before the economic analysis is developed, a preliminary step is to see what evidence there is of fluctuations in rents or sharp changes in the relative price of housing. The existing rent indices show no large fluctuations or sharp rises. However, the indices are the average of the entire market, and anecdotal evidence does support the conclusion that there have been sharp increases in relative rents on specific units or in specific neighbourhoods. If there is occasionally a large rise in relative rents in one district or on one unit, followed by a decline in real rents, the question is whether a different path of adjustment would be a Pareto improvement. Is there a change that can help someone and hurt no one? If during the market adjustment process, tenants moved in and out of units as the relative price rose and fell and resources moved in and out of the housing sector, then it might be argued that a smooth price path would be more efficient, since some of the resources used to move tenants in and out and to move other resources in and out could be saved. But there is no evidence of any such on-again, off-again adjustment.[26] Rent regulation would hold rents down,

slow the flow of resources into the housing sector, and lengthen the period of adjustment. There seems no strong reason to argue that the unregulated market will shift resources into housing too quickly, that is, move resources so that their value elsewhere is greater than their benefit in the housing sector. There does not appear to be a Pareto improvement possible by altering the adjustment path of rents. There may, however, be a case for altering the path in order to redistribute income; that is taken up in the next section.

The other argument for rent regulation on effiency grounds is a "second-best" argument. If there is some barrier to Pareto efficiency elsewhere in the economy, perhaps caused by another government program, that cannot be removed, the best policy would be to remove the barrier; the second-best policy is to make another intervention elsewhere that would offset the barrier and yield a Pareto improvement. It has been argued that the price of housing services acquired through home-ownership is reduced because of government housing assistance programs and because of the special tax treatment of homeowners under the income tax system. Those subsidies cannot be removed, so a second-best policy is to reduce rents. Even if the argument were correct, rent regulation would not be a solution because the offsetting subsidy would have to lower the price of housing to renters and also increase the supply of rental housing. Both could be done by a shelter allowance for renters. Rent regulation does reduce the rents on the controlled stock, but it also reduces the total quantity of rental housing. And rent regulations with exemptions raise the rent on the exempt stock.

Another second-best argument is that municipal land use regulations limit the supply of rental housing. If the demand were to increase, rents would rise but would not attract resources at the efficient rate because of the municipal restrictions. It might, therefore, be a Pareto improvement to hold rents down and thereby shift consumers' expenditures to the non-housing sectors. Unfortunately, economic theory gives no a priori guidance whether this is the case and the question has not been investigated by researchers. Again, however, there may be distributional grounds for altering the rent adjustment. Somewhat analogously, in a world with capital market constraints that limit the availability of loans there may be too much mobility because tenants who anticipate future increases in income cannot obtain loans to pay as much rent as they would be willing to pay. And because landlords do not pay the costs they impose on tenants from eviction, there may be too much eviction. If landlords remove tenants by raising rents, rent controls might achieve a Pareto improvement by reducing evictions.

Most economic analysis of the efficiency of the private market has assumed that households and firms are fully and equally informed about rents, the availability of apartments, and the characteristics of all apartments and also that there are no costs to changing apartments. Clearly, in housing markets, not everyone has the same information and transaction costs are high. It cannot be shown that the market is efficient, but by the same token it cannot be shown how a policy will produce a Pareto improvement. Similarly, most arguments in favour of government intervention have dealt with a first-best world. There are few general results showing the efficacy of second-best interventions.

Of course, it is not usually claimed that regulations are desirable on efficiency grounds; on the contrary, rent regulations introduce inefficiency and it is argued that their removal would be a Pareto improvement. In a market economy, Pareto efficiency will be realized if consumers pay the marginal cost of production (including a normal rate of return) of the goods that they buy. Then the value to society of a unit of a good is just equal to the value to society of what must be given up to produce the good. This is because the value to society of the unit is measured by the consumer's willingness to pay, that is, the price paid, and the value to society of what is given up is measured by the cost of production. Rent regulations break down this basic relationship, and the result is Pareto inefficiency.

In the economics literature Pareto inefficiency is often referred to by comments such as "the housing stock is too small," "the level of new construction is too low," "tenants' mobility is reduced," "tenure choice is distorted," "household formation is distorted," "there is a mismatch of tenants and dwelling units," or "the level of maintenance is too low" under rent regulation. Economics does not have some absolute standard of what the level of housing stock, or tenant mobility or maintenance should be. Rather the above statements are based on a comparison with a Pareto efficient world. The housing stock is too low compared to a Pareto efficient level and so on. The cost to society of the inefficiency is the difference between the value of output in a Pareto efficient world and the value of output under rent regulation. For example, the efficiency cost of housing stock that is too small is the difference between what consumers are willing to pay for additional units in housing stock and the cost

of producing the stock (i.e., the value of what is given up to produce the additional units). The cost of a mismatch between tenants and dwelling units is what each household would be willing to pay to achieve a correct matching.

It is the Pareto efficiency costs that economists are referring to when they speak of the costs of rent regulation. The idea of an efficiency cost is subtle and often difficult to grasp. But the idea is also very powerful and emphasizes things that are often forgotten in policy analysis. It points out that the cost of something is what you must give up to achieve it. More housing is not always better for society because something must be given up to get more housing. It also emphasizes that many costs of rent regulation are by their very nature invisible, for they are the difference between what we could have had and what we actually have. The idea of efficiency costs also provides a rigorous underpinning for such statements as "the housing stock is too small" or "tenant mobility is too low" because it offers a criterion for establishing what the best level of housing stock and mobility would be. All too often in debates on public policy, people say housing construction is too low without naming the criteria on which their statements are based. Unfortunately, there are no estimates of the efficiency costs of rent regulation.[27]

There is, perhaps, one efficiency cost that is somewhat easier to grasp and to measure. That is the cost of administering and enforcing the program, of complying with the program, and of lobbying to have the program remain or removed. If rent regulation did not exist, the resources used in these activities could be

used to produce things that would increase our well-being.

In sum, there may be some cases where rent regulation can produce a gain in efficiency, but the arguments are very speculative. There are much stronger arguments that regulation introduces considerable inefficiencies, although we have no actual measurements of the size of the inefficiencies. Although a balancing of the arguments is at present not possible, the burden of proof must lie on those who would rationalize rent regulation on Pareto efficiency grounds.

8 REDISTRIBUTION OF INCOME

The final social value to consider is that the distribution of income should be fair, or equitable. Again an intuitive idea of what is meant is possible, but it is harder to specify what the precise social consensus is with regard to income distribution. People's incomes come from many sources and are influenced by many things. Your income is influenced by how many hours you work, how hard you work, how much training you have, how much you have saved, and your innate ability. But it is also influenced by luck, discrimination, the political influence of your type of labour, the relative demand for, and supply of, people providing services like yours, and by macroeconomic policy. It is an almost universally accepted view that society is better off if governments act to make the distribution of income more equal than it would be in a laissez-faire world. The redistribution of income is regarded as a legitimate function of government.

That function of government is closely akin to the task of ensuring that all consume adequate housing,

clothing, education, food, medical care, and so on, but distinguishable from it. In the former case the issue is people's general well-being; in the latter, it is the absolute level of consumption of basic necessities. In the former case, the way people spend their money is not an issue; in the latter case it is the central issue.

What is not clear is just how equal the distribution of income should be. It is unlikely that Ontarians desire complete equality. We accept the fact that people are entitled to extra rewards if, for example, they take greater risks, work longer hours, or save more. Moreover, it is recognized that a massive redistribution of income would reduce the size of the pie to be distributed. Thus, something between complete equality and the laissez-faire world is to be desired. It is generally agreed that two principles should govern the redistribution. The first is that there should be horizontal equity, that is, that similar people should be treated in a similar way. For example, two identical families with the same income should pay the same income tax. The principle is similar to equal treatment under the law. The second principle is that there should be vertical equity, which means that dissimilar people should be treated dissimilarly. In connection with taxation this usually means that people should pay higher absolute amounts and higher percentages of their incomes as their incomes rise. The tax system should be progressive (certain taxes may not be progressive, but in its entirety the system should be progressive). When one thinks of all the changes wrought by government through taxes, expenditures, and regulation, vertical equity is usually taken to mean that the better off are net contributors and the worse off are net gainers. The ratio

of net contribution (net gain) to income should rise (fall) as initial income rises. This is simply to say that the intervention of government in a laissez-faire world should make the income distribution more equal.

Although it is clear that society does not want a laissez-faire world, it is much less clear whether it desires more redistribution than there is now. Data on the distribution of money income are widely available, although the data on income broadly defined to include income in kind, such as the flow of services from owner-occupied housing or the value of public services received, are less readily available. The data reveal that the distribution of income in Canada has been relatively stable over the last fifteen years, which suggests that our political system has revealed no strong desire to change the overall distribution of income. Attention seems directed much more toward assisting specific disadvantaged groups, such as native peoples, women, or the disabled. If that is so, there is no need to search for an optimal government intervention to redistribute income: rent regulation will not be needed nor will any other instrument. It is also highly unlikely that rent regulation could be regarded as a preferred substitute for the progressive income tax, the old age pension, the Canada Assistance Plan, free education and health care, and so on. If income redistribution were desired, changes in those programs would be preferable to rent regulation.

Thus, rent regulation cannot be justified solely on the grounds of redistribution of income. However, should regulation be used in pursuit of other social objectives, its effect on the distribution of income is of interest because society does wish the distribution of income to remain fair. Any change caused by rent

regulation should be horizontally equitable and, most people would agree, should also be neutral or slightly progressive.

The distribution of income is altered by rent regulation in many ways. If a household enjoys a lower rent per unit of housing service, then that household's income can be thought of as being raised by an amount equal to a cash grant that would leave the household just as well off if the price reduction were taken away. If a price rises or the rate of return to your assets falls or your wages go down, the loss in income is equal to the income that could be taken from the household while leaving the household just as well off and reversing the price rise or wage fall. Rent regulation also causes permanent, one-time capital losses and perhaps gains.

To sort out the redistribution caused by rent regulation is a subtle, complex theoretical task and perhaps an impossible empirical task. The short-run effects in the rental market are obvious. Tenants in controlled units gain, tenants in uncontrolled units probably lose, and owners of buildings at the time controls are imposed lose. As we know, however, from studying the redistribution caused by taxes, there will be important general equilibrium effects throughout the economy. As resources leave the housing sector and as tenants in controlled units spend their money on other things, the relative price of labour and capital may change and there will be a complicated pattern of changes in commodity prices and rates of return to factors of production. Rent regulation can be thought of as a tax on the returns to capital in one use (rental residential housing) with the proceeds given to

those who occupy controlled housing. The final redistribution results from this tax-subsidy arrangement.[28]

The longer binding controls remain (and so the more capital leaves the residential sector to escape the higher rate of taxation), the harder it is to analyse the redistribution. In the short run, however, especially since we know taxes are borne even in a general equilibrium world by immobile factors of production, the obvious results probably give a fairly accurate picture: tenants in controlled units gain, tenants in exempt units lose, and owners of controlled buildings lose. Who resides in the controlled as opposed to the uncontrolled sector depends on how the controlled stock is rationed. Unfortunately we know relatively little about the characteristics of owners of rental buildings and, consequently, little about who bears the costs of controls. But under most hypotheses about benefits and costs, rent regulation seems mildly progressive. It is vertically equitable in that it has made the broad distribution of income more equal.

However, rent regulation is horizontally inequitable because similar tenants are not treated similarly and because similar non-tenants are not treated similarly. If two tenant households have the same income and family characteristics and both are in controlled units, the increase in income each enjoys will vary depending on how much housing they consume. The more housing consumed, the greater the gain in income. Under Ontario's rent review system, tenants receive different income gains depending on the financing of their building and depending on whether the building has been sold during the control period. Similar people also receive very dissimilar treatment depending on whether they end up in the controlled or

the uncontrolled market. One group enjoys a fall in its rent and so an increase in income. The other group suffers a rent increase and consequently a loss in income. Residents at the time controls were imposed gain, while newcomers or those who want to move are losers. New arrivals, new households, or those selling houses to move into rented housing are hurt by the imposition of regulation. As has been explained above, rent regulation can be viewed as a tax-subsidy scheme. The subsidies are not distributed with horizontal equity. The tax burden falls on existing landlords, especially those who cannot move their resources out of the housing sector. Normally, a tax to finance a subsidy scheme would be levied on all taxpayers.

Yet the public opinion polls suggest there is widespread support for rent regulation. One wonders how widespread the support would be if regulation were replaced by an explicit tax-subsidy program, with the taxes levied on all taxpayers. Would people favour a tax increase in order to give grants to all tenants (provided only that their rent was less than $750 a month)? It is likely they would not, especially if, under the program, the grant to tenants got larger as their income rose (the more they spent on rent). There might be support for some redistribution to tenants but only if the benefits were carefully targeted.

It is conceivable that, although society does not favour a general redistribution, it does wish to reverse the income and capital gains that occur as housing markets adjust to unanticipated shocks in demand or supply. Suppose there were an unanticipated permanent increase in demand and rents moved to a new higher long-run equilibrium; existing producers would then realize a windfall gain (especially in their

capacity as landowners). It may be that society believes such gains should not accrue to existing producers but should rather be shared. If society believes the gains should be shared by everyone, then a windfall gains tax would be the appropriate policy. If society believes that the gains should be returned to consumers in proportion to their levels of consumption, balancing income gains and losses, then a rent regulation system would be a suitable policy. Either a universal or a system with exemptions could be used.

Before this argument could be offered for rent regulation, it would have to be shown that rents would have risen owing to an unanticipated increase in demand and that owners of existing buildings would have enjoyed above-normal profits. Then a rent regulation system that would redistribute the windfall gain could be justified. But it must be emphasized that the system would allow existing landlords a normal rate of return. Existing owners would have no incentive to move their resources to other sectors because those sectors would not offer a higher rate of return. There would be little effect on new supply because new suppliers could still enjoy a normal rate of return and would not greatly fear the extension of controls because the controls do not prevent a normal rate of return.

Another cause for the price increase might be that the new producer has faced a sharp cost increase, although the existing producer has not. New producers need a higher price to enjoy a normal rate of return, while existing producers do not need the higher price and are enjoying a windfall gain. Again, if the gains are to be returned to consumers in proportion to their consumption, a rent regulation system that exempted new

units and held rents on controlled units down but allowed a normal rate of return would be a possible response (but tenants in exempt units would not gain from the redistribution).

A similar sort of argument could be made for redistributing above-normal profits that are made during a period of market adjustment (the new equilibrium might be the same as the original rent level). The most direct solution would be to tax above-normal returns at 100 per cent and then to redistribute the gains to everyone. If society believes that the gains should be redistributed to people in proportion to their consumption (although that is unlikely because a rich tenant would get more than a poor tenant), then what is needed is a universal system of controls that alters the adjustment path of rents but not the long-run rent. Existing owners must be afforded a normal rate of return. There would be no need to exempt any units because new units would also get a normal return.

In a market economy, above-normal profits in a particular sector are a signal that resources should be moved into that sector because people value what is produced there more than what must be given up in order to obtain the increased production. This signalling function must be retained, and therefore any rent regulation must permit some above-normal profits. The question is whether the temporary above-normal profits can be redistributed and the signalling mechanism retained. Furthermore, there will be a trade-off between equity and efficiency if the market path of adjustment is efficient. It should be noted that this argument for rent regulation would call for similar regulation or taxation in all sectors. The costs of

administering, policing, and complying with the regulations, even in the housing sector, would be enormous. The case for redistribution is much stronger if resources cannot flow into the housing sector - the signal brings no response. This can be the case in wartime, or when municipal regulations restrict the supply of serviced land.

The arguments for redistribution of unanticipated profits or capital gains are strangely silent on how to treat windfall losses. Should landlords not be compensated for losses if the gains are to be taken away? If not, the redistributive regulation will cause the long-run equilibrium rent to be high enough to ensure that returns are the same as could be expected in other sectors. Furthermore, there is the fundamental question of why gains from owning residential rental real estate should be taxed any differently than other sources of income. The trend in income tax reform is to treat all forms of income similarly.

Another possible argument for rent regulation is to prevent the redistribution that could occur between a landlord and a tenant, perhaps an elderly tenant faced with very high costs for moving. In this case a landlord might not simply accept the market rent but might raise the rent until the present value of the difference between actual rent and market rent in future years was just less than the cost of moving. Such rent increases may be what is meant by "unconscionable increases." There is no evidence one way or the other on the extent of the phenomenon, but certainly it would not occur for even a small percentage of tenants. A government program to deal with specific allegations would be far better than an blanket policy like rent regulation.

These arguments for rent regulation based on the redistribution of above-normal profits have been developed, not to give them credence, but because they seem to be implicit in the thinking of some proponents of rent regulation. By carefully laying out the conditions necessary to justify the intervention on the grounds of demand changes, cost changes, and society's attitude to redistribution, it is hoped the analysis can then concentrate on finding out whether such conditions actually exist. The discussion has also emphasized that, even if the conditions exist, the rent regulations in responding to those conditions would permit owners of existing buildings a normal rate of return.

9 CONCLUDING REMARKS

The search for society's values that might provide rationales for rent regulation produced six values. After each had been defined more carefully and the effects of rent regulation analysed, what emerged was a complex pattern of effects, some judged desirable according to the values, others undesirable. Rent regulation cannot enable people who do not have adequate housing to obtain adequate housing. Universal binding controls greatly reduce the supply of housing. Binding controls with exemptions raise the price on new supply and, no matter how many additional regulations are added, tend to reduce the existing stock. In aggregate, people are more poorly housed, not better housed, under rent regulation. Some people will be better housed, but more will be less well housed. The desire for affordable housing was found to be a proxy for the belief that everyone is entitled to adequate housing and, as well, to adequate food, clothing, medical care, education, and so on; but it was a bad proxy.

Furthermore, rent regulation was a poor way to ensure people had adequate levels of all goods; but again there was a beneficial side in that poor tenants could buy more of other things under rent regulation. Rent regulation does increase the security of tenure of tenants by preventing some tenants from having to move as a result of sharp price increases. However, most tenants would not have moved anyway, and rent regulation merely prevents many tenants in controlled units from having to shift their expenditure into housing and away from other things. Furthermore, because regulations that are binding increase the incentive to allow dwellings to depreciate or to convert or demolish a unit, security of tenure is reduced. Rent regulation also restricts the property rights of landlords. A possible justification for rent regulation was offered by Pareto efficiency, but the argument was very tentative and much stronger arguments point to the fact that regulations create efficiency losses. Finally, there appeared to be little desire for income redistribution and, if there had been, rent regulation would not have been preferable to the existing instruments of redistribution. Rent regulation might be rationalized as a means of redistributing transitional above-normal profits or windfall capital gains, but it would still have to answer the question of how losses should be treated, how investment can be attracted, and why this particular source of income should be taxed more heavily than others.

If rent review were removed, all the effects listed above would be reversed; again the social values should be used to judge the changes. Just as the imposition of rent review had some results that could be deemed desirable and some that could be deemed undesirable, so the removal would have mixed effects.

A final analysis would require some way of valuing the absolute level of all effects, using a similar unit of measurement so the net change could be established. There must be some way of making trade-offs. This is not done here because all the analysis of effects has been qualitative rather than quantitative.

While the picture that emerged was mixed, nevertheless the balance of the analysis was against the use of rent regulation. Several rationales were found, and of course one could say "that is all I care about, so I favour rent regulation." However, the benefits could usually be better achieved by other means. Most of the arguments were highly speculative, and it remains to show that the conditions justifying regulation exist.

Yet one must confront the fact that a large majority of the residents of Ontario seems to support rent regulation. This section cannot offer an explanation for that, but it does offer a few speculative concluding comments. Partly it is because there are more tenants than landlords, and the landlord has always had an unpopular reputation. It is partly because rent review in Ontario is probably not so binding as to have extremely good or bad effects. There is also a failure to understand that in a market economy supply will be reduced if prices are below cost. In part it results from the uncritical acceptance of the affordability concept. Rent review in a tautological sense reduces affordability problems. In part the support for rent regulation comes from our inability to deal with the turbulence and uncertainty of the last decade, when we have had high and variable rates of inflation, changes in relative prices, low growth in real income, and high unemployment. Anecdotes about specific people who have been hurt have

led to blanket policies. We have naively believed that by regulating one price we could make almost everyone better off. And finally, when we are dealing with the necessities of life, there is always a special tension between the consumer and the producer. The debates about teachers' salaries, food price supports, doctors' salaries, and hospital user charges are similar. If rent review must remain, perhaps the best recommendation to make from the analysis in this paper is that controlled landlords should be allowed a normal rate of return.

NOTES

1. In one view of the political process, government can be seen as articulating and acting on the collective will. In another view, government (and politicians) can be seen as rational and self-interested and as acting to maximize the probability of re-election or to impose their own views. Even if this view is accepted, in Ontario we still regard the process of government as the legitimate way of deciding which values are acted upon. See O.E.C. (1977) for a discussion of the two views. However, criticisms of housing policies under the latter view must be based, not on social values about housing, but on beliefs about what the best decision-making process is.

2. The academic literature is large. Even the important works cannot be cited here. Good bibliographies are available in Arnott (1981), Cheung (1975), Cullingworth (1982), Miron and Cullingworth (1983), Ontario (1982), and Smith and Tomlinson (1981).

3. It could be that the path of adjustment of rents influences the long-run equilibrium level but this possibility is ignored.

4. The essential issue is not the shift in preferences but rather a shift in the equilibrium spatial rent pattern. This could be caused by changes in preferences or in commuting costs or many other things.

5. Strictly speaking, landlords have the option of using cost-pass-through, raising rent by the

guideline amount, or accepting the market rent if it is lower than the other two levels.

6. Descriptions of rent review in Ontario are available in Arnott (1981) and Ontario (1982).

7. This two-step procedure can be useful, but it is not rigorous. A proper analysis would analyse all the effects simultaneously. Moreover, the controlled rents and the rents if there were no controls might be the same, but controls would still have some effects. See note 9.

8. There is a large literature dealing with the effects of rent regulation. Good bibliographies are available in the sources listed in note 2.

9. Frankena (1975) points out that if only the gross rent per dwelling unit is controlled, then landlords may reduce the services provided by the dwelling unit and controls can even raise the price of housing services and landlords can earn above normal profits.

10. This assumes that in the long run land is perfectly inelastically supplied and capital elastically supplied. To the extent that capital cannot be quickly removed from the controlled sector, landlords suffer capital losses as owners of capital.

11. See Fallis and Smith (forthcoming) for a more extensive analysis of controls with exemptions.

12. See Frankena (1975).

13. See Arnott (1981) for a good discussion of optimal maintenance. The reduction in maintenance will be influenced by the method of setting rents. Cost-pass-through controls attempt to mitigate the decline in maintenance.

14. See CMHC (1981).

15. The value that all are entitled to adequate levels of a range of commodities is very closely allied with the value that there should be a fair distribution of income, which is discussed below. This interpretation of the affordability of housing is not general in the housing literature but is the conclusion of the author.

16. In applying this measure, there are numerous problems of measuring housing expenditure and household income, but they are not central to the argument.

17. See CMHC (1982, Table 87).

18. The diversion seems complete in much debate about rent review. The rule is applied with no reference to the underlying logic. Middle-income households that are adequately housed and that have an adequate supply of other necessities are declared to have an affordability problem because they spend more than 25 per cent of their income on rent.

    The weakness of the affordability rule is fully illustrated when one considers the effect of a price reduction policy on households. To the extent that households consume more housing in

response to a price fall and increase their housing expenditure, their affordability problems are increased. A large reduction in the percentage of income spent on housing would occur if the policy meant the household did not consume any more housing.

19. For a discussion of landlord and tenant law and security of tenure see Miron and Cullingworth (1983).

20. The most likely cause of rent increases is that a district of a city has become relatively more popular. This combined with income declines at the end of the life cycle have probably meant some elderly persons have had to move. It is likely that people have also moved following declines in their income caused by unemployment, divorce, or the withdrawal of a member of the household from the labour force.

21. All tenants enjoy some increase in security because the likelihood that a price hike will force them to move is reduced, although the likelihood was already very low.

22. Under a regime of controls where a unit becomes exempt when a tenant leaves, tenants' insecurity is greatly increased. Also, under any control system where excess demand is high and vacancy rates are low, landlords will have no trouble in re-renting a unit, and so a landlord who wishes to harrass a tenant whom he dislikes until the tenant leaves will have a lower cost in doing so. Again insecurity is increased.

23. The concept is named after an Italian economist, Vilfredo Pareto.

24. The value is more controversial than they realized, in part because people care about their relative well-being and in part because not only Pareto improvements are recommended but also potential Pareto improvements (see below).

25. See Fallis (1983) and citations therein.

26. There is evidence of cycles in new residential construction, and some argue that a government program to smooth the cycle would improve efficiency. However, rent regulation would not achieve this.

27. Arnott (1981) provides a good discussion of measuring the efficiency cost of rent regulation.

28. See Mieszkowski (1972) for an examination of the incidence of the property tax. The framework would be applicable to studying the "tax" on the return to investment in rental residential property caused by rent regulation.

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